FILE COPY

MAR 6

No. ~~719~~ 60

In the Supreme Court of the United States

OCTOBER TERM, 1929

CHARLES H. NAUTS, COLLECTOR OF INTERNAL REVENUE, PETITIONER

v.

W. L. SLAYTON

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT, AND BRIEF IN SUPPORT THEREOF

INDEX

	Page
Petition:	
Statement	2
Specification of error to be urged	3
Reasons for granting the writ	3
Brief in support of petition:	
Opinions below	5
Jurisdiction	5
Question presented	5
Statute involved	5
Statement	6
Argument	6
Conclusion	13

CITATIONS

Cases:	
American National Co. v. *United States*, 274 U. S. 99	9
Anderson v. *Forty-Two Broadway Co.*, 239 U. S. 69	10
Consolidated Gas, Electric Light & Power Co. v. *United States*, 65 C. Cls. 252, certiorari denied, 278 U. S. 612	10
Florida v. *Mellon*, 273 U. S. 12	11
Metcalf & Eddy v. *Mitchell*, 269 U. S. 514	12
National Life Insurance Co. v. *United States*, 277 U. S. 508	3, 7, 9
New Creek Co. v. *Lederer*, 295 Fed. 433	10
Plummer v. *Coler*, 178 U. S. 115	11
United States v. *Anderson*, 269 U. S. 422	9
United States v. *Barwin Realty Co.*, 25 F. (2d) 1003	10
Willcutts, Collector of Internal Revenue, v. *Bunn*, No. 535, October Term, 1929	13
Statutes:	
Revenue Act of 1921, c. 136, 42 Stat. 227, 237, 239—	
Sec. 213	5
Sec. 214	6

In the Supreme Court of the United States

OCTOBER TERM, 1929

No. ——

CHARLES H. NAUTS, COLLECTOR OF INTERNAL REVENUE, petitioner

v.

W. L. SLAYTON

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT, AND BRIEF IN SUPPORT THEREOF

PETITION

The Attorney General, on behalf of Charles H. Nauts, Collector of Internal Revenue for the Tenth District of Ohio, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Sixth Circuit entered in the above-entitled case on December 6, 1929 (R. 16), affirming the judgment of the United States District Court for the Northern District of Ohio. (R. 7, 8.)

STATEMENT

During the year 1922 the respondent was engaged in the business of buying, selling, and dealing in bonds. In that year he received as interest from municipal bonds owned by him $65,720.06. In addition he received other income the source of which is not disclosed by the record, which, less all deductions allowed by the statute, amounted to $106,704.78. During the year he paid as interest on money borrowed to buy and carry the municipal bonds the sum of $78,153.84. In making his income-tax return for the year 1922 he excluded the amount of the interest received by him from the municipal bonds, and included the remainder of his income; but he deducted the interest paid on the money borrowed to buy and carry the municipal bonds. (R. 2.)

Upon review and audit of this return the Commissioner of Internal Revenue disallowed this deduction, and assessed an additional tax for 1922 of $32,606.49. This additional tax, together with interest amounting to $7,778.04, the respondent paid on demand under protest on August 4, 1927. (R. 2, 3.) He then filed a claim for refund which was rejected. (R. 5.)

The respondent thereupon filed his petition in the United States District Court for the Northern District of Ohio to recover said sum (R. 1, 2) and the petitioner demurred thereto. (R. 6.) The District Court overruled the demurrer and, upon fail-

ure of the petitioner to answer, entered judgment for the respondent. (R. 7, 8.) From this judgment, an appeal was prosecuted to the Circuit Court of Appeals for the Sixth Circuit (R. 8–11), which sustained the District Court (R. 16, 19).

SPECIFICATION OF ERROR TO BE URGED

The Circuit Court of Appeals erred in holding that Congress could not constitutionally refuse to permit, in the computation of taxable net income, the deduction of interest paid on indebtedness incurred to purchase and carry tax-exempt bonds, while allowing the deduction of other interest paid.

REASONS FOR GRANTING THE WRIT

The decision of the Circuit Court of Appeals declares unconstitutional the provision of Section 214 (a) (2), of the Revenue Act of 1921, which denies permission to deduct interest paid on indebtedness incurred to buy or carry tax-exempt securities while allowing the deduction of other interest paid. The question of the power of Congress to enact this provision is an important one which has not been but should be passed on by this Court.

The Circuit Court of Appeals decided that to deny the deduction of such interest paid is in effect to tax State obligations. In so deciding that court probably incorrectly applied the decision of this Court in the case of *National Life Insurance Co.* v. *United States*, 277 U. S. 508, which held that Section 245 (a) (2) of the Revenue Act of 1921 was invalid

in so far as it undertook to reduce the 4 per cent deduction of the mean reserve fund of a life insurance company by the amount of interest received from tax exempt securities. It is believed that the present case is not within the scope of that decision, as in this case there is no necessary relation between the income from the bonds and the amount of interest paid on indebtedness incurred to buy or carry them.

The question is far-reaching in its application and importance and affects a large number of taxpayers.

Another phase of the question of the constitutional limits of the taxing power of Congress, as affecting the obligations of States, will come before this Court in *Willcuts* v. *Bunn*, No. 535, October Term, 1929, in which certiorari to the Circuit Court of Appeals for the Eight Circuit was granted on January 27, 1930.

Wherefore, it is respectfully submitted that this petition for a writ of certiorari to review the judgment of the Circuit Court of Appeals for the Sixth Circuit should be granted.

WILLIAM D. MITCHELL,
Attorney General.

MARCH, 1930.

BRIEF IN SUPPORT OF THE PETITION

OPINIONS BELOW

The memorandum opinion of the District Court (R. 7) is not reported. The opinion of the Circuit Court of Appeals (R. 16) is reported in 36 F. (2d) 145.

JURISDICTION

The judgment of the Circuit Court of Appeals for the Sixth Circuit was entered December 6, 1929. (R. 16.) The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Is it within the constitutional power of Congress to withhold from taxpayers, in the computation of taxable net income, the right to deduct interest paid on indebtedness incurred to purchase or carry obligations of a municipality, while permitting the deduction of other interest paid?

STATUTE INVOLVED

The Revenue Act of 1921, c. 136, 42 Stat. 227, 237, 239:

> SEC. 213. That for the purposes of this title * * * the term "gross income"—
>
> * * * * *

(b) Does not include the following items, which shall be exempt from taxation under this title:

* * * * *

(4) Interest upon (a) the obligations of a State, Territory, or any political subdivision thereof, or of the District of Columbia; * * *

SEC. 214. (a) That in computing net income there shall be allowed as deductions:

* * * * *

(2) All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title;

* * * * *

STATEMENT

A statement of the facts and the error to be relied upon will be found in the petition.

ARGUMENT

The Act expressly excludes from the definition of gross income interest from obligations or securities of a State or a political subdivision thereof. Section 213 (b) (4), *supra*. The question is whether the refusal of Congress to permit the deduction from gross income, in arriving at the net

income, of interest paid on indebtedness incurred to purchase or carry such obligations, while allowing the deduction of other interest paid, is in substance a tax upon the obligations. The Circuit Court of Appeals held that the result is to tax directly the income from the obligations, and it relied upon the decision of this Court in *National Life Insurance Co.* v. *United States,* 277 U. S. 508. That case is cited also for the proposition that one may not be subjected to greater burdens upon his taxable property because he owns property that is nontaxable. It is submitted that that decision is not applicable to the situation in the instant case, and that the provision here in question does not have the effect apprehended by the Circuit Court of Appeals.

The *National Life Insurance Company case* involved the interpretation of a different section of the 1921 Act, viz., Section 245, which defines net income in the case of life insurance companies. Net income is there defined as gross income less (1) the amount of interest received during the taxable year from tax-exempt securities, and (2) an amount equal to 4 per cent of the company's mean reserve funds, diminished, however, by the amount of the first deduction, *i. e.* the interest from tax-exempt securities.

Thus there was in that case a direct and inevitable relation between the amount of deduction for tax-exempt interest and the amount of deduction otherwise allowed as a percentage of the reserve

fund. Here there is no necessary relation between the nontaxable income and the deductions allowed in determining taxable net income. The exemption from tax of the income from State obligations extends to every citizen, and the taxpayer is not subjected to any greater burden by reason of his ownership of such obligations. The amount of taxable income does not depend upon the ownership of or receipt of interest from tax-free securities. Taxpayers having the same "taxable" income are not treated differently because one owns tax-free securities. The Act gives to all taxpayers the same deductions. No one is entitled to deduct interest paid on indebtedness incurred to purchase or carry municipal bonds, and, on the other hand, everyone is entitled to deduct all other interest.

It is only where the taxpayer incurs indebtedness to buy or carry such securities that the question can arise, and then the amount of interest paid on the indebtedness bears no necessary relation to the amount of nontaxable income.

The limitation does not affect one who owns or receives income from tax-free securities differently from one who does not. It distinguishes between one who borrows money for the purpose of producing nontaxable income and one who borrows for other purposes. The respondent had the benefit and advantage of the exemption of the income. The asserted disadvantage to him arose because he chose to borrow money to buy or carry the tax-free

securities. One who did not incur such indebtedness suffered no disadvantage. The real situation seems to be that respondent claims an additional benefit because he has incurred the indebtedness.

It is submitted that the above facts are sufficient to take the case out of the principles laid down in the *National Life Insurance Company case.*

The limitation of the interest deduction first appeared in Section 1201 of the Revenue Act of 1917, c. 63, 40 Stat. 300, 330. It has appeared in all subsequent Revenue Acts. Its manifest purpose was to exclude from the calculation of taxable income expenses which did not arise from the production of such income. Cf. *United States* v. *Anderson,* 269 U. S. 422, 440; *American National Co.* v. *United States,* 274 U. S. 99, 104. Without this limitation, the borrowing of money for investment in tax-free bonds may be the means of avoiding the tax on income from other sources. One who invests his entire capital of $100,000 in taxable securities pays a tax on the interest he receives from them. Were there no limitation, he could invest in tax-free securities an equal amount of borrowed money and exempt his *entire* income from taxation, assuming that interest rates are equal. The restriction merely denies the deduction from taxable income of expenditures made in producing income that may not be taxed. It is justified by the practical necessity of preventing such borrowings for the purpose of evading the tax on other income. Otherwise, there

would be discrimination against those who do not own tax-free securities. Congress is not under the duty of offering special advantages to the holders of tax-free securities.

A taxpayer has not an inherent right to any deduction. Deductions are a matter of legislative discretion and authority for all deductions must be found in the statute. *New Creek Co.* v. *Lederer*, 295 Fed. 433, 435; *Consolidated Gas, Electric Light & Power Co.* v. *United States*, 65 C. Cls. 252, certiorari denied, 278 U. S. 612.

It is likewise settled that, in determining the taxable income, Congress may limit the amount of interest which may be deducted from gross income. *Anderson* v. *Forty-Two Broadway Co.*, 239 U. S. 69; *United States* v. *Barwin Realty Co.*, 25 F. (2d) 1003.

Before the Circuit Court of Appeals, respondent also argued that the interest paid to carry municipal bonds by one whose business was buying and selling bonds was an ordinary and necessary expense of the business that must be deducted in computing taxable income. However, this contention was rejected by the Circuit Court of Appeals because the circumstances of the present case do not bring it within the special circumstances under which interest may be treated as "ordinary and necessary expenses" suggested by this Court in *Anderson* v. *Forty-Two Broadway Co.*, *supra*. Manifestly, the Circuit Court of Appeals was cor-

rect in this view, since the deduction of interest is specifically covered by subdivision (a) (2) of Section 214.

Since it has been shown that the taxpayer receives full benefit of exemption from tax of the municipal securities and the income therefrom, the only other point at which the provision in question could infringe the constitutional guaranty is in a restriction of the market for such bonds creating a burden on the borrowing power of the State. But the Constitution does not require the United States to hold out special inducements to invest in State bonds, or to assist the State in disposing of its securities. See *Florida* v. *Mellon*, 273 U. S. 12, 17. Moreover, it is well settled that such a restriction is not of itself unconstitutional. The rule is stated by this Court in *Plummer* v. *Coler*, 178 U. S. 115, 137–138, as follows:

> But when the effort is made, as is the case here, to establish the unconstitutional character of a particular tax by claiming that its remote effect will be to impair the borrowing power of the government, courts in overturning statutes, long established and within the ordinary sphere of state legislation, ought to have something more substantial to act upon than mere conjecture. The injury ought to be obvious and appreciable.

Clearly the effect of the limitation in this case on the borrowing power of the municipalities is neither obvious nor appreciable. As this Court

said in *Metcalf & Eddy* v. *Mitchell*, 269 U. S. 514, 523:

> In a broad sense, the taxing power of either government, even when exercised in a manner admittedly necessary and proper, unavoidably has some effect upon the other. The burden of federal taxation necessarily sets an economic limit to the practical operation of the taxing power of the states, and *vice versa*. Taxation by either the state or the federal government affects in some measure the cost of operation of the other.

The only "disadvantage" that a holder of tax-exempt securities may suffer under this restriction, as against a holder of taxable securities, is in a case like the present where the taxpayer places himself in the situation that he is paying more interest to purchase or carry nontaxable securities than he receives upon them. He will then pay more tax than he would if he held taxable instead of nontaxable bonds. To the extent of the excess of interest paid over that received he is deprived of a deduction given to others. This, however, is not a necessary effect of the statute. It is fortuitous—arising not in every case but only in cases where the taxpayer is unfortunate or ill-advised, or finds advantage in paying more interest on the purchase or carrying of tax-free securities than he receives from them during a certain period. If the taxpayer paid less than he received, he would be better off to that extent. That the statute works an occasional hardship is not sufficient to condemn it. In its general

application, the statute does not place the taxpayer at a disadvantage but at most merely fails to give him an additional advantage.

This Court will shortly have before it the case of *Willcuts, Collector of Internal Revenue* v. *Bunn*, No. 535, which involves a related question, viz. the power of Congress to tax the gain derived by the owner of municipal bonds from the sale of such bonds at a profit. The Circuit Court of Appeals for the Eighth Circuit held the tax on such gain unconstitutional. (35 F. (2d) 29.) This Court granted certiorari on January 27, 1930.

CONCLUSION

It is respectfully submitted that the petition for a writ of certiorari in this case should be granted.

WILLIAM D. MITCHELL,
Attorney General.

G. A. YOUNGQUIST,
Assistant Attorney General.

SEWALL KEY,
ANDREW D. SHARPE,
Special Assistants to the Attorney General.

C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue,

T. H. LEWIS, Jr.,
Special Attorney,
Bureau of Internal Revenue,
Of Counsel.

MARCH, 1930.

U. S. GOVERNMENT PRINTING OFFICE: 1930